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When the debtors said no

By Anatole Kaletsky

RIO DE JANEIRO, August 30 (UP) — Official announcement that a partial moratorium had been obtained on foreign debt payments was made today by the Brazilian Government publicity bureau. The Government, it was stated, has decided to suspend temporarily foreign debt payments with the exception of two funding loans and the Coffee Loan.

THESE two sentences, which hit the world's financial markets like "a bolt from the blue," in the words of the following day's Financial Times, had certainly not occurred to Mr Thomas W. Lamont, senior director of J. P. Morgan and Co, on Friday, July 25 the year before Brazil went bust.

At 3 pm that Friday afternoon Mr Lamont, in his capacity as chairman of the International Committee of Bankers on Mexico, felt nothing but pride and satisfaction as he ushered Sr Luis Montes de Oca, the Mexican Finance Minister, into the Morgan Bank's opulent boardroom in Wall Street.

History seemed to be peering over his shoulder as he added his signature to that of the Finance Minister on the agreement which brought to a successful conclusion the biggest-ever renegotiation and settlement of a defaulting country's foreign debts. Here at last was a piece of good news which could provide a ray of hope to the financial world after a year of continuous disasters, the likes of which the world had never seen.

This hope was dimmed, but not yet extinguished, on New Year's Day five months later when the Bolivian Legation in New York issued the following statement:

'Common knowledge' has forgotten about history

"Owing to the current world-wide business depression, the general revenues of the Republic of Bolivia have been temporarily reduced to such an extent that the Republic is not in a position at this time to meet the interest obligations which became due on its external debts on January 1."

Bolivia intended "to fulfil its obligations fully and absolutely," the statement added. But it would need the indulgence of its creditors for a temporary period because of the country's exceptional dependence on exports of tin.

It seemed to be another "special case" that landed three months later on the desk of Mr Charles Mitchell, chairman of the National City Bank of New York. The plaintive letter on his desk from Peru's new Finance Minister, read (in part):

"I am addressing you with respect to the interest due April 1 next on the Peruvian National Loan. This Government took office on March 11 last, after a period of political disturbances extending over six months. It finds the Treasury bare of funds, both as a result of these political disturbances and of the economic depression which has obtained for more than a year. As a result of these conditions, for which the present Government is not responsible, it has not the capacity at this time to pay in full the service charges on the Republic's entire debt."

By the end of that summer, it was no longer possible to talk of "special cases."

In July, two months after Peru's letter, Mr Mitchell received a cable in almost identical terms from the Government of Chile. Then, a month later, on August 30, came Brazil's "bolt from the blue."

With Brazil's "temporary" moratorium, the floodgates were opened. Cables poured in from Ecuador, Colombia and Central America. Within a year only three major Latin American countries—Argentina, Venezuela and the Dominican Republic—were meeting their obligations in full. Soon Hungary, Yugoslavia, Romania, Poland and Bulgaria were also in default. Finally, even Germany blocked its foreign payments as its tough new leader—Adolf Hitler—consolidated power.

Until that last sentence, even the reader with a moderate interest in international finance might have wondered whether all these references to governments "defaulting" and "going bust" were supposed to be fact, forecast or just plain fantasy. After all, it is common knowledge today that countries cannot just "go bust." A government can always pay its debts if the nation is willing to accept temporary sacrifices. Even the most impetuous politicians realise that deliberate default can be tantamount to national economic suicide.

These fundamental truths have been proclaimed so vigorously in recent months, as Latin America and Eastern Europe have appeared to approach the brink of bankruptcy, that "common knowledge" has entirely forgotten about history—about the wave of national defaults which swept through precisely these same regions in the 1930s.

This collective amnesia about the international lending disasters of the 1930s has two possible explanations.

The sovereign defaults in Germany, Austria and other central European countries were due not to excessive commercial borrowing, but to the unsupportable burden of reparations from the First World War. The vast sums involved in these notional defaults on essentially political obligations have tended to divert attention from the sovereign defaults on purely commercial debts. Yet the commercial defaults had mounted to roughly $3bn by 1933—a huge sum in the context of a value of only $24bn for the whole of the world's trade.

Secondly, the international borrowing of the 1930s came mainly from investors in the bond markets, rather than from banks. This left the banking system less exposed to sovereign defaults and bankers themselves less preoccupied by their consequences.

But, despite this important technical difference, the parallels between the debt crises of the 1930s and the 1980s are more than just an historical curiosity.

The superficial features of the 1930's debt crisis should be familiar to anybody who has been following the events of the 1980s.

There was, of course, the geographical distribution of the defaulting nations.

From 1931 onwards the U.S. Congress (with Mr Lamont of Morgan and Mr Mitchell of National City as the first two witnesses) held indignant hearings on the bankers' "scandalous practices and abuses" in pushing loans during the 1920s on unsuspecting foreign dictators.

Commissions of international financial experts—such as Sir Otto Neimeyer of the Bank of England and Professor Edwin Kemmerer of Princeton University—were despatched from Peru to Poland by committees of bankers or by the League of Nations to restore confidence.

But even more interesting and ominous are the possible lessons for the future.

Defaults in the 1930s invariably proved much deeper, longer and more subtle than anybody had expected. Just one month before Brazil began its default on August 30, 1931, for example, Sir Otto found "that Brazil had all but turned the corner on her difficulties."

On December 18, a group of bankers told the New York Times that Mexico had "reached a stage of economic convalescence" and could expect "a period of rehabilitation which will compare favourably" with other major countries. On January 22, 1932, a special session of the Mexican Congress declared the country's agreement with the Lamont committee "a nullity" and suspended all loan payments for three years.

Misapprehensions like these stemmed partly from a curious paradox, which may also prove instructive in the 1980's debt crisis. Governments became more stubborn in their defaults precisely when their economies started improving.

Sir Otto and the bankers were partly right in their economic predictions about Brazil and Mexico. They *were* recovering by 1932—in fact

Sir Otto Niemeyer, of the Bank of England (left) and Mr Thomas W. Lamont, of J. P. Morgan

Brazil's industrial productio grew by 11.8 per cent a yea from 1932 to 1939. But as thes countries consolidated the ravaged economies and returne to political stability, their dete mination and ability to wit stand pressure from foreig creditors grew as well. This exactly what many Brazilian and Mexicans today expect the governments to start doing the next year or two.

No nation in Latin Americ explicitly repudiated its debts, but by 1933 there was no longer any thought of "loyally complying" with external obligations, as promised in the Peruvian letter to the National City Bank in 1931. Indeed, when the Mexican President asserted publicly, in September 1933, that "the present and future financial policy of the Government does not permit of any idea of renewing service on the foreign debt," his statement did not even rate a report in the financial press.

The bond market even picked up slightly when Brazil converted its "temporary" moratorium into a permanent default by stating that it would issue newly-printed bonds for 20 and 40 years in lieu of cash interest payments.

Of course, the major debtors took liberties with their "obligations," partly because the U.S. and British Governments let them get away with it. But here is another lesson from the 1930s. The creditor governments did not unleash retaliatory trade measures against the defaulters or ostracise them from "the community of nations." On the whole, they blamed bankers for "overlending," more than the debtors for failing to pay.

The U.S. and British Governments' insouciance stemmed not just from conscience, or even political expediency, as World War Two made the preservation of alliances in Latin America paramount. Both governments also seemed to remember the lessons of previous history better than their bankers.

Since the 1820s, Latin America had defaulted en masse repeatedly. The losses of the 1930s were accepted as just the latest turn of a well-established 50-year cycle of default, followed by further massive extensions of credit. Experience had shown that lenders had only one real sanction against sovereign defaulters—cutting off new credit.

Normally, after a lengthy period of default a country would seek to re-establish its credit by offering its bondholders a "readjustment," settling their outstanding claims for a fraction of their face value. Most of the Latin American and Eastern European countries lifted their defaults like this in the 1940s and 1950s. Mexico was one of the first in 1943, when it persuaded the Lamont committee to recommend acceptance of less than $50m in settlement of more than $500m of outstanding debts.

The bondholders reluctantly agreed, on the grounds that some payment was better than nothing—and also because many had bought the Mexican bonds as pure speculations at knock-down prices during the country's many protracted periods of total default between 1914 and 1943.

Once an adjustment was agreed by bondholders, the stigma of default was officially expunged and the country could again start seeking credit. Mexico was allowed to borrow from the U.S. Exim Bank as early as 1942, while it was still negotiating with the bondholders, but after it had

A well-established 50-year cycle of default

settled other outstanding claims against it, following the expropriation of U.S. oil companies. Slowly but steadily, it returned to its pre-eminent position as one of the world's greatest debtors.

Nearly four decades later, in April 1961, the Mexican Government approached the sterling bond market for a loan of $50m on behalf of Pemex, the state oil company. The following sentence appeared in the prospectus:

"Full debt service has been paid when due upon all the external debt issued by the Federal Government of Mexico since the adoption of the constitution of 1917 . . ."

The prospectus did not bother to explain this enviable record. For nearly 30 years, from 1914 to 1943, Mexico had defaulted on most of its pre-1914 obligations and was therefore prevented from raising new loans on which it could commit any "fresh" defaults.

That is the sort of fine point that bankers seem willing to leave to the history books.